No. 91-1592

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

H.G.A. CINEMA TRUST,
Burton W. Kanter, Trustee,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. Which of two conflicting standards advanced in the Circuits should be applied to determine the existence of debt for purposes of 26 U.S.C. § 465?

2. In determining the validity of debt and economic exposure, should the rules of bankruptcy law be ignored, or considered as in the view of the Sixth Circuit?

LIST OF PARTIES

The parties to the proceedings below were the Petitioner, H.G.A. Cinema Trust, Burton W. Kanter, Trustee, and the Commissioner of Internal Revenue.

The Respondent before this Court is the United States Department of Justice.

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LECT ON THE NOTE ISSUED AS PART OF THE PURCHASE OBLIGATION IN THE SAME TRANSACTION; THEREBY PLACING THE SAME PARTY WHO IS THE PURCHASER/ LESSOR, ENTITLED TO RECEIVE LEASE PAYMENTS, IN THE POSITION OF BEARING THE RISK OF THE PURCHASE MONEY NOTE WITHOUT CONTINUATION OF THE RIGHT TO RECEIVE CORRESPONDING RENTAL PAYMENTS 12

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H.G.A. CINEMA TRUST,
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v.

UNITED STATES DEPARTMENT OF JUSTICE,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

The Petitioner, H.G.A. Cinema Trust, Burton W. Kanter, Trustee, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered in this proceeding on December 27, 1991.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit, which appears in the Appendix hereto, App. 1, *infra*, is reported at 950 F.2d 1357 (7th Cir. 1991).

The opinion of the United States Tax Court, which appears in the Appendix hereto, App. 2, *infra*, is reported at TCM 1989-370; (July 25, 1989); 57 TCM (CCH) 1066 (July 25, 1989).

JURISDICTION

The judgment of the United States Court of Appeals for the Seventh Circuit, was entered on December 27, 1991, affirming an opinion of the Tax Court of the United States dated July 25, 1989. No petition for rehearing was sought.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

26 U.S.C.A. § 465.

"§ 465. **DEDUCTIONS LIMITED TO AMOUNT AT RISK.**

[Sec. 465(a)]

(a) LIMITATION TO AMOUNT AT RISK.—

(1) IN GENERAL.—In the case of—

(A) an individual, and—

* * *

engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount

with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year.

(2) DEDUCTION IN SUCCEEDING YEAR.—Any loss from an activity to which this section applies not allowed under this section for the taxable year shall be treated as a deduction allocable to such activity in the first succeeding taxable year.

* * *

[Sec. 465(a)]

(b) AMOUNTS CONSIDERED AT RISK.—

(1) IN GENERAL.—For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including—

(A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and

(B) amounts borrowed with respect to such activity (as determined under paragraph (2)).

(2) BORROWED AMOUNTS.—For purposes of this section, a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he—

(A) is personally liable for the repayment of such amounts, or

(B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property.)

No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in paragraph (1)).

(3) CERTAIN BORROWED AMOUNTS EXCLUDED.—

(A) IN GENERAL.—Except to the extent provided in regulations, for purposes of paragraph (1)(B), amounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who has an interest in such activity or from a related person to a person (other than the taxpayer) having such an interest.

(B) EXCEPTIONS.—

(i) INTEREST AS A CREDITOR.—Subparagraph (A) shall not apply to an interest as a creditor in the activity.

* * *

(4) EXCEPTION.—Notwithstanding any other provision of this section, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

* * *

STATEMENT OF THE CASE

The decision below gives rise to a conflict between the Sixth and Seventh Circuit Court of Appeals. Each of the cases before those Circuits involves virtually identical financial arrangements of a complex sale-leaseback transaction, organized by the same promoter.

The best statement of these arrangements appears in the statement of pertinent facts as set forth by the Sixth Circuit Court of Appeals, and the following summary of facts with respect to both the case before the Seventh Circuit Court of Appeals and the case before the Sixth Circuit Court of Appeals is, in large part, a paraphrase of the latter.

There are three major parties to the sale-leaseback transaction: (1) the Leasing Corporation ("Leasing"); (2) Middle Corporation ("Middle"); and (3) the Purchasing Partnership ("Partnership" or "Investor") in which the taxpayer in each case is a partner. In each instance, Middle was the arranger, bringing together Leasing and Investor as part of the overall sale-leaseback transaction.

While the precise amounts, the specific equipment involved, and the time period of the leases and notes, as well as the remarketing terms, differ in each case, and in each case where there was involved more than one transaction, each transaction differed in those respects; in all other respects the transactions are the same, and the form and framework and structure of each is the same. The precise documentation likewise, while differing in the aforementioned items, was essentially identical.

In each instance Leasing purchased computer and/or computer peripheral equipment from a major manufacturer, such as IBM. The purchase price was paid by Leasing borrowing the major portion of the purchase price from an institutional lender, such as a bank, which would be provided a first lien on the equipment. The equipment was leased for a period less than its expected useful life to an end-user. The terms of that lease called for payments which would either fully or largely pay out the lending institution's first lien note. The end-user was the actual user of the equipment, employing same in the conduct of its business.

Following these steps, Leasing would sell the equipment to Middle at a slightly marked up price, subject to the existing end-user lease and subject to the institutional lender lien. Middle would pay a small portion of its purchase price in cash and the balance with a full recourse installment note bearing interest to maturity. Generally, the cash amount would at least equal the amount of the original purchase price paid by Leasing which was not covered by the institutional borrowing by Leasing. The note would have a fixed final date of payment. A resale of the equipment by Middle would trigger certain advance payments under its note to Leasing, which sums would relate to the proceeds on sale received by Middle from its buyer.

Either immediately following closing by Middle and Leasing, or simultaneously, Middle would sell the equipment to Investor on terms and conditions substantially identical to those under which Middle bought the equipment from Leasing, perhaps marked up slightly, with slightly different payment terms, but in all events sufficient to cover the obligations of Middle under its contracts with Leasing, all

subject to the leases to the end-users and subject to the institutional lien. Investor would pay the non-cash portion of the purchase price by short-term promissory notes designated for interest and a longer term partial recourse promissory note bearing interest and a fixed maturity date coinciding with the final fixed maturity date of the note issued by Middle to Leasing. In accordance with the intent of the overall sale-leaseback transaction, in the event Investor leased the equipment (subject to the end-user lease and the institutional lien) certain of the rental receipts would accelerate in favor of Middle (clearly linked to the acceleration of note payments from Middle to Leasing under the purchase contract between them). Investor granted Middle a security interest in the equipment, the leases of the equipment and all proceeds from the leases, subject to the rights of the end-user and the first lienholder.

In conjunction with this step, and again most often simultaneously, Investor would lease back the equipment to Leasing, subject to the first lien, the rights of the end-user and the security interest of Middle. The lease terms would be such that all payments under each of the foregoing transactions would be fully covered and Investor would share in the rents obtained by Leasing upon a release of the equipment following the termination of the lease of the end-user and the satisfaction of the first lien obligation. The leaseback arrangement would provide effectively for the payment of the fixed rents and the note payments in the form of what has been referred to as a "round-robin" of payments among the several parties, usually by bookkeeping entries made by Leasing, rather than a constant exchange monthly of checks.

Petitioner was a partner in Investor in this structure, and the taxpayer in the Sixth Circuit Court of Appeals case was likewise a partner in Investor in this structure.

In each case it was incumbent on the Tax Court in the initial instance to determine the validity of the indebtedness incurred by Investor in the transaction described and to further determine the applicability of the limitation on deduction of losses arising from the transaction from interest and depreciation under Section 465 of the Internal Revenue Code of 1954, as amended. In the case of *Emershaw v. Commissioner*, 940 F.2d 841 (6th Cir. 1991) the Tax Court found in favor of the taxpayer, while in the case below, the Tax Court found in favor of the Government. The Sixth Circuit Court of Appeals affirmed the Tax Court in *Emershaw*, and the Seventh Circuit Court of Appeals affirmed the Tax Court in *H.G.A. Cinema Trust*. The decisions of each Court of Appeals is in direct conflict based on the same essential facts involved in each case and the necessary finding of applicable law with respect to the validity of the indebtedness and the applicability of the statutory limitation on loss deduction.

REASONS FOR GRANTING THE WRIT

I.

THE CONFLICT IN THE CIRCUITS AS TO THE STANDARD TO BE APPLIED IN DETERMINING THE EXISTENCE OF DEBT FOR PURPOSES OF 26 U.S.C. § 465 MUST BE RESOLVED.

In each case, that before the Seventh Circuit and that before the Sixth Circuit, while different parties and different transactions were involved, the transactions were, for all practical purposes, identical in form, structure and documentation and were effectively promoted by essentially the same people. In each instance so-called partial recourse notes issued had a final due date, years after the equipment involved would have any residual value. In each instance there is no issue of the transaction having been entered into for profit or the residual value of the equipment being such as to have supported a profit motive. In each instance each of the Courts considered that the flow of funds was circular and designed to effectively have each payment of purchase price matched by each rental payment. In each instance the payments among all the parties were made in the so-called circular manner by bookkeeping entries, and not by passage of monies through separate bank accounts.

At the heart of each of the cases is the fact that bankruptcy of Leasing (which occurred in each instance) would permit Leasing to renounce the lease it had undertaken and stop making rental payments to Investor. Investor would have a claim for damages against Leasing, but only in the capacity of a general creditor without a right of offset. Nonetheless, Investor would be required to pay

Middle the balance on the partial recourse note by the indicated outside maturity date. In each instance this risk and burden represents the ultimate burden of responsibility for the payment of the partial recourse note and is placed on Investor and no one else. In each instance if the rental payments ceased, the payments under the free partial recourse note ceased until the outside maturity date of payment.

The Court of Appeals in the Sixth Circuit refuses to accept the earlier decision in *Baldwin v. United States*, 904 F.2d 477 (9th Cir. 1991) in the Ninth Circuit and the *Moser et al. v. Commissioner*, 914 F.2d 1040 (Sept. 1990) decision in the Eighth Circuit. The Court of Appeals in the Seventh Circuit relied on the *Moser* decision, but did not cite the *Baldwin* decision and failed to address the *Emershaw* decision of the Sixth Circuit, although the latter was directly called to the attention of the Seventh Circuit.

As the Sixth Circuit points out, the factual circumstances in *Baldwin* involved a three-party sale and leaseback transaction of computer equipment exactly analogous to that involved in the Sixth Circuit case, and, likewise, analogous to that of the Seventh Circuit case.

The Sixth Circuit rejected the idea that the offsetting payments involving the obligations of Leasing, Middle and Investor, effectively protected the participants in Investor from a liability exposure with respect to the partial recourse note. The Seventh Circuit specifically held that the circular offsetting nature of the obligations of Leasing, Middle and Investor represented a basis for concluding that the partners in Investor would sustain no economic exposure.

The Sixth Circuit rejected the Commissioner's view that the *worst case scenario* analysis to determine the economic exposure of the taxpayer involved is not a proper standard for determining the existence of debt exposure. The Sixth Circuit thereby rejected the concept of *economic reality* propounded by the Commissioner. The Seventh Circuit looked to what it considered the *economic reality* and rejected the concept of a *worst case scenario* as a basis for determining economic exposure. The Seventh Circuit considered it unlikely and, thus, irrelevant, that Leasing could become insolvent (despite the fact that it did) and thereby require the partners of Investor to satisfy the obligation on the partial recourse note out of funds other than the rent receipts. The Sixth Circuit considered that to be the primary relevant question. In that respect, the Sixth Circuit rejected the majority reasoning in the *Baldwin* case and considered the dissenting opinion in *Baldwin* as the more appropriate view, whereas the Seventh Circuit would conform its view to that of the majority in *Baldwin*, and not the dissenting view, even though it did not cite *Baldwin* and only cited *Moser*.

The Sixth Circuit pointed out through two examples, which will not be repeated here, the sharp difference in the circumstances that gave rise to economic exposure and economic reality and clearly reached the opposite view to that of the Seventh Circuit.

II.

THE CONFLICT BETWEEN THE SEVENTH CIRCUIT AND THE SIXTH CIRCUIT PRESENTS AN IMPORTANT FEDERAL QUESTION, SEPARATE FROM THE TAX ISSUE, AS TO A CONFLICTING INTERPRETATION OF THE EFFECT OF BANKRUPTCY PROCEEDINGS ON INDEBTEDNESS. THE COURT BELOW, IN DETERMINING THE VALIDITY OF DEBT AND ECONOMIC EXPOSURE, IGNORED THE RISK OF BANKRUPTCY AS IRRELEVANT, CONTRARY TO THE VIEW OF THE SIXTH CIRCUIT.

The failure of the Seventh Circuit to follow the view expressed by the Sixth Circuit with respect to the impact of possible bankruptcy proceedings and the right of the bankrupt estate to disavow the lease obligation while maintaining its position and right to pursue the partial recourse note payments, puts at issue an important element of Federal administration, not only in the tax area, but in the bankruptcy area. Recognition of the impact of a bankruptcy proceeding in a society that witnesses bankruptcies every day of even seemingly the most stable organizations, makes a mockery of a position that says that parties would not enter into a transaction if there were an expectation of bankruptcy. Bankruptcy is never expected, but the possibility of bankruptcy is always understood. The risk inherent in the economic transaction is the possibility, not necessarily the likelihood of bankruptcy. To ignore the reality of the possibility and the understanding of the economic risk involved is to ignore economic reality altogether. Thus, for all Federal purposes, it is important to understand the validity of an obligation which is intertwined with debt service via another obligation in the form of lease rentals. In a society which involves innumerable such financing arrangements, treating the risk of bankruptcy as irrelevant to validity of the debt and economic exposure goes to the heart of the fun-

damental character of what constitutes indebtedness and economic risk and exposure in a commercial society.

III.

THE DECISIONS OF THE SEVENTH CIRCUIT AND THE SIXTH CIRCUIT LEAVES IN CONFLICT APPLICATION OF THE FEDERAL TAX "AT RISK" RULE, WHICH DOES NOT APPLY TO AN OBLIGATION WHICH IS ULTIMATELY BORNE BY A TAXPAYER AND IS NOT SUBJECT TO REIMBURSEMENT OR GUARANTEE.

Section 465 of the Internal Revenue Code (26 U.S.C. § 465) was adopted as a limitation on the allowability of deductions that are based on indebtedness incurred in conjunction with transactions that give rise to deductions attributable to tax basis which includes such indebtedness. The limitations under Section 465 are intended to preclude the availability of those deductions if, in fact, there is no economic risk to the participant by reason of some valid guarantee of repayment or offsetting provision. The ingredients and elements of the fundamental characterization of indebtedness and economic exposure under Section 465 are intimately intertwined and cannot be separated where the essence of each is not dependent on a non-third party guarantee, but only on the findings that would be attributable to a circular, round-robin set of payments growing out of the strategic aspects of each leg of the sale leaseback transaction. So long as debt is due once and for all at some given date, the circularity of the payments can be of no consequence in either context and both contexts are merged since the circularity of payments either recognizes the debt or does not, and recognizes the economic risk or does not. In both instances, if, as pointed out by the Sixth Circuit, the termination of the circularity gives rise to economic risk, then it must be applicable in

all circumstances. The Seventh Circuit chose to ignore this perspective and did not recognize the risk inherent therein.

The Sixth Circuit opinion is clearly in conflict with the decision of the Ninth Circuit in *Baldwin v. United States*, 904 F.2d 477 (9th Cir. 1990). The conflict in the Circuits is with *Baldwin* and the Seventh Circuit on one hand, versus the Sixth Circuit on the other. The Sixth Circuit pointed out that the structure of the obligations, which was considered to be a circular, offsetting group of obligations established by the sale leaseback transaction, was not to be a "loss-limiting device of any sort". The Sixth Circuit found that were Leasing to become insolvent and stop paying rent, nonetheless the partners in Investor would be called upon to satisfy the terms of the partial recourse note. Therefore, their investment was one of economic risk. The same is clearly true of the parties in *H.G.A. Cinema Trust.* Most importantly, as pointed out by the Sixth Circuit, it could "see no reason for dismissing the possible bankruptcy of [Leasing] as a mere theoretical possibility" when "in fact, it has already occurred as was clear at trial". The same conditions existed in *H.G.A. Cinema Trust*, but the Seventh Circuit elected to ignore the fact of bankruptcy, as well as the possibility of bankruptcy.[1]

[1] In *Emershaw*, the parent of Leasing was a guarantor of the obligation but the Sixth Circuit concluded that the parent might have well gone bankrupt and there would still be liability on the partial recourse note. It points out that the effect would simply be the prospect of diminishing the likelihood of the circle of offsetting obligations and payments being interrupted. That concept would not have been acceptable to the Seventh Circuit, in which case there was no such guarantee and interruption was the more likely prospect.

(Footnote continued on following page)

CONCLUSION

For each of the foregoing reasons, the Petitioner respectfully prays that a writ of certiorari issue to review the opinion of the United States Court of Appeals for the Seventh Circuit to resolve the questions presented herein.

Respectfully submitted,

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March, 1992

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[1] *continued*

Further conflict exists between the two Courts of Appeal in the fact that in the Seventh Circuit, as in the Ninth Circuit, the Court concluded that the parties lacked independent means to meet their obligations and considered that a relevant factor in this circular offsetting bookkeeping arrangement to the issue before it. The Sixth Circuit in *Emershaw* considered that it was at a loss to understand the argument. It pointed out that no matter how circular the arrangement, nothing exempts the transaction from the risks involved and the Court concludes that the obligation exists. Whether the obligation can ultimately be paid is a circumstance not predictable and not relevant to the validity of the economic obligation or the risk undertaken at the outset.

APPENDICES

APPENDIX A

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 90-2101

HGA CINEMA TRUST,
BURTON W. KANTER, TRUSTEE,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court
Nos. 37830-85, 39610-85—**B. John Williams, Jr.**, *Judge*

ARGUED APRIL 15, 1991—DECIDED DECEMBER 27, 1991

Before BAUER, *Chief Judge*, COFFEY and MANION, *Circuit Judges.*

BAUER, *Chief Judge.* In this appeal, we must decide whether a partnership's long-term promissory notes represent valid debt. The United States Tax Court held that these notes were not valid indebtedness. We affirm.

I.

The pertinent facts of this case have been set forth ably by the United States Tax Court. *See HGA Cinema Trust, Burton Kantor, Trustee v. Commissioner of Internal Revenue*, 57 T.C.M. (CCH) 1066 (1989). Here, we need only

recite those facts essential to our decision. Petitioner-appellant HGA Cinema Trust ("HGA"), whose trustee is tax attorney Burton W. Kanter, held a 5.56 percent interest in the profits and losses of a limited partnership called SLG during each of the taxable years 1978 through 1981. The tax deficiencies that are the subject of this appeal arose from the sale of computer equipment to SLG and its leaseback of this equipment.

The principal corporate participants in the transactions at issue are O.P.M. Leasing Services, Inc. ("O.P.M."), Funding Systems Leasing Corporation ("Funding"), Pluto Leasing Corporation ("Pluto"), and Knight Leasing Corporation ("Knight"). O.P.M. and Funding (the "leasing corportations") were engaged in the equipment leasing business. The leasing corporations purchased certain computer and peripheral equipment from end users and then leased that equipment back to the end users. To finance part of the purchase price, each leasing corporation obtained a nonrecourse loan from an institutional lender, secured by a lien on the equipment and an assignment of the rentals payable under the end users' leases. These transactions among the leasing corporations, the lenders, and the end users, were valid multiparty transactions that had economic substance.

On June 30, 1978, Funding and O.P.M. entered into several agreements with Pluto and Knight (the "intermediary corporations") involving the sale and leaseback of certain computer equipment. On the same date, the intermediary corporations sold this equipment to SLG, and SLG assumed the intermediary corporations' rights and obligations under their leaseback agreements to Funding and O.P.M. To understand the facts underlying this appeal, we must describe these rather complex transactions in greater detail.

The Funding-Pluto-SLG Transactions

Funding agreed to sell the leased equipment to Pluto subject to the lender's lien and rights under the lease of end user. Pluto purchased the equipment for $2,700,000,

payable as follows: $5,000 in cash, $25,000 by noninterest-bearing promissory note due on July 31, 1978, and $2,670,000 by a limited recourse promissory note that was to be paid in 96 monthly installments with an 10.4 percent annual interest rate.

On the same date, June 30, 1978, Pluto agreed to lease the computer equipment back to Funding for a term extending through June 30, 1986. In addition to the terms of the rent, the lease agreement provided that "[Funding] will indemnify [Pluto] and protect, defend and hold it harmless from and against any and all loss, cost, damage, injury or expense . . . which [Pluto] may incur by reason of any breach by [Funding] of any of the representations by, or obligations of, [Funding] contained in this Lease . . . ." Funding and Pluto also executed a remarketing agreement in which Funding agreed to remarket the computer equipment after the termination of Pluto's lease, and Pluto agreed to pay Funding ten percent of all proceeds from the remarketing agreement.

On the same date, SLG purchased from Pluto the computer equipment that Pluto had acquired from, and leased back to, Funding. Pluto assigned its rights and interests in the equipment and in the lease to SLG, subject to the prior lien of the lenders, the rights of the end users, and the rights of Funding pursuant to its leasing agreement with Pluto. SLG assumed all of Pluto's obligations arising out of its purchase, leasing, and remarketing agreements with Funding. SLG did not assume Pluto's long-term note or short-term recourse notes. SLG purchased the equipment from Pluto for $2,705,000—$5,000 more than Pluto paid to Funding for the equipment. The terms of payment, however, were almost identical: $5,000 in cash, $25,000 by negotiable promissory note due on July 31, 1978, and $2,670,000 by long-term promissory note containing the same terms as Pluto's long-term note to Funding. The additional $5,000 was to be paid by a $5,000 negotiable promissory note due on March 31, 1979. SLG anticipated the cash flow generated by these transactions to be $200 per month, which represents the difference between the

rent due on the lease between Funding and Pluto, and the monthly payments that SLG was obligated to pay on the long-term note to Pluto.

The long-term note between SLG and Pluto contained the following provisions:

> 5.2 *Deferral.* In the event the Lease is terminated prior to the expiration of the Lease term, on account of an Event of Default as defined thereunder, then, notwithstanding anything herein to the contrary, the entire unpaid principal amount of this Note, together with all interest accruing hereunder shall be deferred and shall not be due and payable until June 30, 1993, at which time all such unpaid principal and accrued interest shall become due and payable; provided, however, that notwithstanding such deferral to the extent Payor shall receive any proceeds from the Equipment following a termination of the Lease as aforesaid, it shall be obligated to pay such proceeds to the Senior Lienholder on account of the Debts (and such payment shall be deemed to prepayments under this Note).
>
> 5.3 *Extension, Set-Off and Discharge.* Debtor shall have, in addition to all other rights and remedies it may have, the right to defer payment of (but not reduce the amount of) each and every payment of principal and interest as the same becomes due hereunder if and to the extent any amount of rent or other sum becoming due to Debtor under the Lease is not paid by Funding as the same becomes due (the "Past Due Sum"). The amount of principal and interest so deferred will become due and payable at such time as, and to the extent that, Funding pays to Debtor such Past Due Sum; provided, however, that no interest shall accrue on the principal and interest payments so deferred. Any Past Due Sum remaining due to Debtor at the expiration or sooner termination of the Lease will serve to reduce the unpaid principal and interest on this Note at that time.

The O.P.M.-Knight-SLG Transactions

On June 30, 1978, O.P.M., Knight, and SLG entered into a series of transactions not materially different from the Funding-Pluto-SLG transactions, for the sale and leaseback of a 45 percent interest in certain used computer equipment. The format was essentially the same: Knight conveyed to SLG a 45 percent interest in the equipment that was the subject of the sale and leaseback between O.P.M. and Knight. Specifically, O.P.M. agreed to sell certain computer equipment to Knight, subject to the lien of the lender and the rights of the user. The purchase price was $5,005,655, payable as $25,000 in cash, $25,000 by negotiable, noninterest-bearing promissory note due July 31, 1978, and $4,955,655 by limited recourse promissory note. This limited recourse note was payable in 96 monthly installments with a 10.2 percent annual rate of interest.

Knight leased the equipment back to O.P.M. on the same day, June 30, 1978, for a term extending through June 30, 1986. The Knight-O.P.M. lease contained an indemnification clause identical to that contained in the Funding-Pluto lease. Knight and O.P.M. also entered into a remarketing agreement for the period following the expiration of the lease. Pursuant to the remarketing agreement, Knight agreed to pay O.P.M. ten percent of all net proceeds from remarketing.

On June 30, 1978, SLG agreed to purchase from Knight a 45 percent interest in the equipment for $2,257,045, payable as follows: $11,250 in cash, a non-interest bearing note for $11,250 due July 31, 1978, a non-interest bearing note for $4,500 due March 31, 1979, and a long-term recourse note for $2,230,045. The cash payment, the $11,250 note, and the long-term note are exactly 45 percent of the corresponding terms from Knight to O.P.M., and the payment terms on SLG's long-term note were exactly 45 percent of the corresponding terms of Knight's long-term note to O.P.M. The long-term note contained provisions identical to those in SLG's note to Pluto.

As was the case with the Funding-Pluto-SLG transactions, Knight assigned all its rights and interests in the equipment and lease to SLG, and SLG assumed all of Knight's obligations under its agreements with O.P.M., except for Knight's debt obligations to O.P.M. SLG anticipated that its transactions with O.P.M. and Knight would generate a monthly case flow of $160. This sum represented the excess of the rental payments from the Knight-O.P.M. lease over SLG's monthly payments on its long-term note.

The Bankruptcies

O.P.M. and Funding filed bankruptcy petitions under Chapter 11 of the Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 1-1330 (1988), on March 11, 1981, and October 23, 1981, respectively. In the course of the proceedings, SLG, Pluto, and Funding agreed to an assumption, modification, and compromise of controversies with respect to the sale and leaseback transactions. SLG, Knight, and O.P.M. entered into similar agreements. The bankruptcy court approved the modifications.

These agreements provided that SLG's cash flow of $200 and $160 per month, including amounts past due and amounts not yet due, would become unsecured general claims against Funding and O.P.M., respectively. Funding's and O.P.M.'s lease payments were reduced to eliminate the net cash flow to SLG. As a result, the lease payments from Funding to SLG, the note payments from SLG to Pluto, and the note payments from Pluto to Funding were of equal amounts. Similarly, the lease and note payments between O.P.M., SLG, and Knight were of equal amounts. The modifications also provided that the rent and note payments were to offset each other and the order in which the rental and note payments were due was reversed.

SLG, HGA, and the Proceedings Below

On June 30, 1978, SLG expected the equipment to have a residual value at the end of the leasebacks on June 30,

1986, of at least seven percent, net of marketing fees and other expenses. SLG expected the residual value to decline to near zero by June 30, 1993, the deferral date in the long-term notes.

The parties stipulated that the transactions had economic substance and that SLG had a profit motive in entering into the transactions with Pluto and Knight. SLG, therefore, acquired a depreciable interest in the equipment on June 30, 1978. SLG used $4,962,000.45 as its basis in the equipment in computing its depreciation deductions on its federal income tax returns. This amount represented the total cost of the equipment it purchased, including the face value of the long-term notes.

SLG received $3,600 from Pluto and $2,280 from Knight on or shortly after February 28, 1980. These amounts represent the monthly cash flow from the transactions for the 18-month period from July 1978 through December 1979. SLG reported rental income, depreciation, and interest expense from the sale leaseback transactions in 1979, 1980, and 1981 as follows:

	1979	1980	1981
Rental Income	$480,366	$1,044,022	$1,041,862
Depreciation	(827,077)	(827,007)	(827,007)
Interest Expense	(640,532)	(479,255)	(418,905)

HGA, as a partner in SLG, reported and deducted its distributive share of the partnership's losses and investment interest expense for the years in issue on its federal returns as follows:

	1979	1980	1981
Income (loss)	($19,074)	$11,926	$11,747
Interest Expense	(8,706)	(12,525)	(11,919)

The Commissioner of Internal Revenue ("Commissioner") sent HGA a notice of deficiency for the tax years 1978 through 1980 and for tax year 1981 which, among other things, disallowed all income and deductions from the sale-

leaseback transactions and imposed additional interest and various penalties under the Internal Revenue Code.

HGA filed petitions for redetermination of the deficiencies with the United States Tax Court, and the actions were consolidated. In his amended answers, the Commissioner asserted that the long-term promissory notes given by SLG to Knight and Pluto did not constitute valid indebtedness. HGA disagreed and argued that the notes could be enforced if the leasing corporations declared bankruptcy and the trustees in bankruptcy rejected the underlying leases. The Commissioner responded that even if the SLG notes represent valid indebtedness, HGA was not "at risk" within the meaning of section 465 of the Internal Revenue Code (the "Code"), 26 U.S.C. §§ 1-9602 (1988), for the principal of these notes. Section 465 generally provides that a taxpayer may deduct a loss from an activity only to the extent of the amount he has "at risk" in the activity, such as cash or property contributed to the endeavor, as well as amounts borrowed for which the taxpayer is personally liable for repayment.

The Tax Court sustained the Commissioner's disallowance of HGA's losses and deductions attributable to SLG on the ground that SLG's long-term notes did not represent genuine indebtedness. It relied on the discharge, deferral, and indemnification clauses. Under the discharge clause, SLG's obligation to make note payments was in essence subject to the leasing corporations' obligation first to pay rent. Under the deferral clause, note payments were deferred until June 30, 1993, if the leasing corporations defaulted and their leases were terminated. On that date, the equipment would be worthless and the leasing corporations' and intermediary corporations' nonrecourse notes could be satisfied by surrendering the worthless equipment. Thus, they could not recover from SLG. Finally, although SLG's notes purported to be recourse notes, any rent not realized by SLG due to a leasing corporation's default on a lease was a loss or damage subject to indemnification pursuant to the lease. Thus, the Tax Court

found that SLG's note payments, were, in effect, payable solely out of rental receipts.

The Tax Court rejected HGA's argument that there was genuine indebtedness because a trustee in bankruptcy could reject the leases. It considered "implausible" the argument that SLG entered these transactions expecting the leasing corporations to declare bankruptcy, and it pointed out that the evidence suggested that bankruptcy was not likely in 1978, 1979, or 1980. Furthermore, the trustee-in-bankruptcy and debtor-in-possession for O.P.M. and Funding did not, in fact, reject the leases or attempt to collect on SLG's notes when the corporations did in fact declare bankruptcy. On the contrary, the modifications of the notes, approved by the bankruptcy court, simply continued the circularity of the offsetting rent and debt obligations. Finally, the Tax Court observed that, had the leases been rejected, SLG had substantial legal arguments that the notes were *not* recourse but that the obligations on the notes were wholly dependent on realizing rentals under the lease agreement.

The Tax Court sustained the Commissioner's imposition of additional interest under the section 6621(c)(3)(A)(ii) of the Code, which imposes interest of 120 percent of the applicable rate on tax underpayments exceeding $1,000, if the underpayments are attributable to any loss disallowed by reason of section 465(a). It relied on Code section 465(b)(2)(A), which provides that a taxpayer is at risk with respect to amounts borrowed for use in an activity to the extent that he is personally liable for repayment of such amounts. Because the notes did not represent valid indebtedness, they were not amounts borrowed for which HGA was personally liable for repayment. Thus, the loss in question was disallowed by reason of section 465(a), and HGA was liable for additional interest.

The Tax Court also sustained the imposition of additions to tax pursuant to Code section 6651(a)(1) (failure to file timely return) and section 6653(a) (negligence). Relying on *United States v. Boyle*, 469 U.S. 241 (1985), the court held

that the reliance placed by Kanter, a tax attorney, on a clerical employee to file the trust's return does not constitute reasonable cause for its untimely filing of its 1979 return. HGA appealed from the Tax Court's decision.

II.

HGA, as noted above, was a partner in SLG. Under section 704(d) of the Code, a partner's distributive share of a partnership loss is allowed only to the extent of the adjusted basis of his interest in the partnership at the end of year in which the loss occurred. As a general rule, any increase in a partner's share of the partnership's liabilities is considered a contribution of money to the partnership, and increases a partner's basis in the partnership. *See* Internal Revenue Code, §§ 705(a), 722, 752(a). *See also* Arthur B. Willis, *Partnership Taxation* § 52.05 (4th ed. 1991). Nevertheless, for HGA's proportionate share of the partnership's debt to be included in its basis, the debt must be genuine. Thus, the sole issue before us is whether SLG's long-term promissory notes constituted a valid and binding indebtedness.

HGA argues that the Tax Court's decision that SLG's long-term promissory notes did not represent valid debt is erroneous and should be reversed. We are not persuaded. Genuine indebtedness consists of "the unconditional and legally enforceable obligation for the payment of money." *Autenreith v. Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940). Contingent or speculative obligations do not represent valid indebtedness and cannot be included in a taxpayer's basis. *See Durkin v. Commissioner of Internal Revenue*, 872 F.2d 1271, 1276 (7th Cir.) ("When . . . the debt used to purchase an asset is unlikely to be paid by the taxpayer, that debt does not represent a bona fide capital investment by the taxpayer and will be excluded from the depreciable basis of the asset."), *cert. denied*, 493 U.S. 824 (1989). *See also Lewis v. Commissioner of Internal Revenue*, 328 F.2d 634, 635 (7th Cir.) ("Regardless of a taxpayer's motives, where a paper trans-

action lacks substance and no genuine indebtedness is created . . . no interest can be said to have been paid for the use or forbearance of money actually loaned and no interest expense deduction may flow therefrom."), *cert. denied*, 379 U.S. 821 (1964).

In the instant case, the Tax Court correctly held that SLG's obligation to make payments on the long-term notes was not an unconditional obligation but instead was subject to the leasing corporations' promise to pay the rent due. Indeed, the language of the long-term notes from SLG to the intermediary corporations provided that SLG had "the right to defer payment of . . . principal and interest as the same becomes due hereunder if and to the extent any amount of rent or other sum becoming due to [SLG] under the Lease is not paid by . . . [the lessee] as the same becomes due." The note payment deferred in this manner became due only when, and to the extent that, the lessee paid the past due rent. In other words, under the terms of long-term notes, SLG had no obligation to "pay" on the notes except to the extent that Funding or O.P.M. paid rent.

The deferral clause further demonstrates that the indebtedness was not genuine. If a lease was terminated as a result of an event of default, such as the filing of a bankruptcy petition, SLG's obligation on its note was deferred for fifteen years from the date of execution of the note—until June 30, 1993. On that date, the parties expected the equipment to have virtually no value. The leasing corporations' and the intermediary corporations' nonrecourse liabilities, then, could be satisfied by forfeiting the nearly worthless equipment. Although SLG's notes are labelled "recourse," it is unlikely that the intermediary corporations would be able to enforce them because they would be in no different financial situation than when the offsetting rent and note payments were being made. *See Moser v. Commissioner of Internal Revenue*, 914 F.2d 1040, 1048-49 (8th Cir. 1990) ("[I]n deciding whether the Strothmans . . . were not at risk on the portions of their recourse notes, we inquire whether the arrangement re-

moved any realistic possibility that they would suffer an economic loss if the underlying transaction turned unprofitable. Economic reality is our guide. . . . [T]he circular nature of the arrangement . . . effectively immunized the Strothmans from economic loss.")

Moreover, in the leases, the leasing corporation agreed to indemnify and hold harmless the intermediary corporations from "any and all loss, cost, damage, injury, or expense . . . which Lessor . . . may incur by reason of any breach by Lessee of any of the representations by, or obligations of, Lessee contained in this Lease . . . ." By the plain language of this provision, the indemnity encompasses not only the obligation to maintain the tangible property, as HGA contends, but also the obligation to pay rent. Because SLG was the assignee of the intermediary corporations' rights of indemnity, it could respond to any suit on the notes by seeking indemnity from the leasing corporations. Thus, the structure of the relationships between SLG and the various leasing and intermediary corporations indicates that the notes do not, in fact, constitute genuine indebtedness.

Nevertheless, HGA maintains that the long-term notes represented valid indebtedness because of the potential effects of a bankruptcy. HGA argues that, if the leasing corporations went bankrupt, their trustees-in-bankruptcy would have the legal right to reject the leases. This rejection, according to HGA, would eliminate the rental offset referred to in paragraph 5.3 of the long-term notes because pre-petition rental obligations cannot be offset against post-petition note obligations. Appellant's Brief at 10-11. Under this theory, SLG would have no right to offset the note payments with the unpaid rentals and would be subject to claims for collection of the notes. In HGA's view, SLG would then be liable (thus proving the genuineness of the debts) on the notes and have only a claim as a general creditor against the bankrupt estate.

The Tax Court considered this argument and, as we hold, properly rejected it. The Tax Court refused to ac-

cept the implausible argument that SLG entered into these transactions with a view that the leasing corporations would declare bankruptcy. We agree. As the Tax Court found, there is no evidence to suggest that bankruptcy was a realistic or anticipated event when the parties structured their relationships. Moreover, as the Tax Court noted, the actual consequences of the bankruptcies in 1981 support the holding that the long-term notes did not represent genuine indebtedness. The trustee-in-bankruptcy and the debtor-in-possession did not reject the lease and attempt to collect on SLG's notes. Instead, SLG, the intermediary corporations, and the leasing corporations agreed to modify the long-term notes: SLG's cash flow was eliminated, the rental payments were made equal to the note payments, and the priority of the payments was reversed so that the note payments would be credited prior to the leasing corporations' rental payments. Yet SLG retained the offset and deferral rights contained in the original notes. Thus, as the Tax Court properly determined, even with the modifications, the closed circularity of the offsetting rent and debt obligations persisted—the change was in form only: with the modifications, the rent was to be subtracted from the debt; previously, the debt had been subtracted from the rent. Consequently, the potential effects of bankruptcy cannot transform HGA's "obligations" into genuine indebtedness. Because these notes did not represent valid debt, they can neither be included in basis nor support a deduction for interest expense. *Knetsch v. United States*, 364 U.S. 361 (1960).

HGA's remaining claims merit far less attention. Suffice it to say that the Tax Court properly held that an addition to tax pursuant to section 6651(a)(1) of the Code was warranted by HGA's failure to file its federal return on time and because the transactions were tax-motivated. HGA's trustee, a tax attorney, cannot escape the provisions of section 6651 by blaming an employee for that employee's failure to follow the trustee's directions. It is well-settled that a taxpayer has a personal, nondelegable duty to file the return when due, and reliance on an agent

cannot constitute reasonable cause to excuse the taxpayer's failure to file on time. *Boyle*, 469 U.S. at 247. HGA's contention that the employee deceived the trustee about whether the return was filed does not alter the trustee's duty to see that the return was filed on time.

Similarly, the additional interest imposed on underpayments attributable to tax-motivated transactions pursuant to section 6621(c)(3)(A)(ii) also was warranted. As the Tax Court determined, the language of section 6621 includes losses disallowed by reason of invalid debt. Because HGA's losses arise out of long-term notes that do not represent genuine indebtedness, they are disallowed. Thus, we agree with the Tax Court that additional interest pursuant to section 6621(c) is proper.

For the foregoing reasons, the decision of the Tax Court is

AFFIRMED.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

APPENDIX B

[57 TCM 1066]

[CCH Dec. 45,871(M)] HGA Cinema Trust, Burton W. Kanter, Trustee v. Commissioner.

Docket Nos. 37830-85, 39610-85. T.C. Memo. 1989-370. Filed July 25, 1989. [Appealable, barring stipulation to the contrary, to CA-7.—CCH.]

* * * * *

Memorandum Findings of Fact and Opinion

WILLIAMS, Judge: The Commission determined deficiencies in petitioner's Federal income tax and additions to tax for the taxable years 1978, 1979, 1980 and 1981 as follows:

	Additions to Tax		
§ *6651(a)(1)*[1]	§ *6653(a)*	§ *6659(a)*	
—	—	—	
6,388.99	1,352.00	—	
—	1,567.00	—	
—	—	5,755.00	

	Deficiency
1978[2]	$ 3,936.43
1979	25,551.00
1980	31,345.00
1981	39,443.00

[1] All section references are to the Internal Revenue Code of 1954 as in effect for the years in issue, unless otherwise indicated.

[2] The statute of limitations on assessment for the year 1978 is open solely pursuant to section 6501(j).

The Commissioner also claimed an increase in interest pursuant to section 6621(c) for the taxable years at issue. The issues presented are: (1) whether certain long-term promissory notes of petitioner's partnership issued in connection with the purchase of computer equipment represent valid indebtedness; (2) whether the additions to tax pursuant to sections 6651(a)(1) and 6653(a) are warranted; and (3) whether the increase in the interest rate pursuant to section 6621(c) is appropriate. Based on the stipulations, respondent conceded the section 6659(a) addition to tax. This is a test case for a number of cases involving other limited partners in petitioner's partnership.

Findings of Fact

Some of the facts have been stipulated and are so found. Petitioner, HGA Cinema Trust, is a trust whose address is in Chicago, Illinois. Petitioner's trustee is Burton W. Kanter, a tax attorney. Petitioner timely filed U.S. Fiduciary Income Tax Returns (Forms 1041) for the taxable years 1978, 1980 and 1981. Petitioner filed its return for the taxable year 1979 on November 5, 1981.

The principal corporate participants in the transactions at issue are O.P.M. Leasing Services, Inc. ("O.P.M."), Funding Systems Leasing Corporation ("Funding"), Pluto Leasing Corporation ("Pluto"), and Knight Leasing Corporation ("Knight"). O.P.M. and Funding (the "Leasing Corporations") both were engaged in the equipment leasing business during the years at issue. Pluto and Knight (the "Intermediary Corporations") bought the Leasing Corporations' interest in the equipment and sold it to investors in the transactions at issue after leasing it back to the Leasing Corporations.

SLG is a limited partnership formed under the laws of Connecticut. The general partner of SLG is The Holding

Company, a corporation formed under the laws of Delaware, owned principally by various family trusts for the benefit of Burton W. Kanter's family members. Petitioner had a 5.56-percent interest in profits and losses as a limited partner of SLG during each of the taxable years 1978 through 1981.

On June 30, 1978, Funding, Pluto and SLG entered into transactions for the sale and leaseback of certain used computer equipment. O.P.M., Knight and SLG also entered into transactions for the sale and leaseback of a percentage interest in certain other used computer equipment on June 30, 1978. Joel Mallin was the promoter of these transactions.

The Leasing Corporations purchased various computer equipment that was installed with end users by assuming the end users' purchase obligations with the equipment manufacturer or vendor. The Leasing Corporations leased the equipment back to the end users. To finance most of the purchase price, the Leasing Corporations obtained a nonrecourse loan from an institutional lender (the "Lender") secured by a first lien on the equipment and by an assignment of the user lease. At closing, the Lender advanced the present value of the future lease rentals. With these funds, the Leasing Corporations were able to pay a major portion of the total cost of the equipment to the manufacturer or vendor required by the assumed purchase obligation. The sale and leasebacks among the Leasing Corporations, the Lenders and the end users were valid multiparty transactions the form of which had substance.

Funding, Pluto and SLG

Concurrently with or subsequent to closing with the Lender, but also on June 30, 1978, Funding agreed to sell

the leased equipment to Pluto subject to the lien of the Lender and the lease rights of the end user. The purchase price in the agreement between Funding and Pluto was $2,700,000, payable $5,000 in cash, $25,000 by negotiable promissory note due on July 31, 1978, without interest, and $2,670,000 by limited recourse promissory note.

The limited recourse note was payable in 96 monthly installments with annual interest at the rate of 10.4 percent. The first 18 monthly payments were interest only, in the amount of $23,140 each. The remaining payments of principal and interest were $47,237.13 each.

Pursuant to the terms of the long-term note, and in partial satisfaction of the interest due, Pluto executed and delivered to Funding a fully recourse non-interest-bearing promissory note in the principal amount of $70,000 due July 31, 1978. The $70,000 note represented $11,666.67 of each of the first six months' payments on the long-term note. Also, on June 30, 1978, pursuant to the terms of the long-term note, Pluto executed and delivered to Funding a promissory note in the principal amount of $89,000 bearing interest at the rate of eight percent due on March 31, 1979. The $89,000 note represented $7,416.67 of the next twelve months' payments on the long-term note.

Pluto agreed to lease the computer equipment back to Funding on June 30, 1978, for a term extending through June 30, 1986. The lease agreement provided for a net lease with rent payable as follows: $11,673.33 for each of the first six months of the lease term; $15,923.33 for each of the next 12 months of the lease term; and $47,437.13 for each of the remaining 78 months of the lease term. The lease agreement also provided that "Lessee [Funding] will indemnify Lessor and protect, defend and hold it harmless from and against any and all loss, cost, damage,

injury or expense * * * which Lessor * * * may incur by reason of any breach by Lessee of any of the representations by, or obligations of, Lessee contained in this Lease * * *."

Funding and Pluto also executed a remarketing agreement on June 30, 1978. Funding agreed to remarket the equipment after Pluto's lease to Funding terminated. Pluto agreed to pay Funding ten percent of all net proceeds from the remarketing.

Also on June 30, 1978, Pluto and SLG entered into a Purchase Agreement with respect to the equipment Pluto had acquired from and leased back to Funding. Pluto assigned its rights and interests in the equipment and lease to SLG subject to the prior liens of the Lenders, the rights of the end users and the rights of Funding pursuant to its agreements with Pluto. SLG assumed all of Pluto's obligations arising out of its purchase agreement, lease agreement and remarketing agreement with Funding. SLG did not assume Pluto's long-term note or short-term recourse notes. The purchase price in the agreement between Pluto and SLG was $2,705,000 payable $5,000 in cash, $25,000 by negotiable promissory note due on July 31, 1978, $5,000 by negotiable promissory note due on March 31, 1979, and $2,670,000 by long-term promissory note.

The payment terms of SLG's long-term note to Pluto were identical to the payment terms of the long-term limited recourse note Pluto gave Funding. SLG also executed and delivered to Pluto notes for prepaid interest in the principal amounts of $70,000 and $89,000, identical (but for the parties) to the notes Pluto gave Funding. The evidence shows that SLG paid these short-term notes but does not indicate when SLG paid them. The parties stip-

ulated that SLG is entitled to deduct the interest it paid on the $89,000 promissory note.

After reduction for the interest prepayments, the required monthly payments pursuant to SLG's long-term note to Pluto were $11,473.33 for the first six months, $15,723.13 for the next twelve months and $47,237.13 for the remaining 78 months. The difference between the rent due on the lease between Funding and Pluto that SLG acquired and the amounts of monthly payments SLG was obligated to pay on the long-term note to Pluto was $200 per month. Two hundred dollars is the monthly cash flow SLG anticipated the transaction would generate.

The long-term note contained the following provisions:

> 5.2 *Deferral.* In the event the Lease is terminated prior to the expiration of the Lease term, on account of an Event of Default as defined thereunder, then, notwithstanding anything herein to the contrary, the entire unpaid principal amount of this Note, together with all interest accruing hereunder shall be deferred and shall not be due and payable until June 30, 1993, at which time all such unpaid principal and accrued interest shall become due and payable; provided, however, that notwithstanding such deferral to the extent Payor shall receive any proceeds from the Equipment following a termination of the Lease as aforesaid, it shall be obligated to pay such proceeds to the Senior Lienholder on account of the Debts (and such payment shall be deemed to be prepayments under this Note).
>
> 5.3 *Extension, Set-Off, and Discharge.* Debtor shall have, in addition to all other rights and remedies it may have, the right to defer payment of (but not reduce the amount of) each and every payment of principal and interest as the same becomes due hereunder if and to the extent any amount of rent or other sum becoming due to Debtor under the Lease

> is not paid by Funding as the same becomes due (the "Past Due Sum"). The amount of principal and interest so deferred will become due and payable at such time as, and to the extent that, Funding pays to Debtor such Past Due Sum; provided, however, that no interest shall accrue on the principal and interest payments so deferred. Any Past Due Sum remaining due to Debtor at the expiration or sooner termination of the Lease will serve to reduce the unpaid principal and interest on this Note at that time.

O.P.M., Knight and SLG

On June 30, 1978, O.P.M., Knight and SLG entered into a transaction, not materially different from the Funding-Pluto-SLG transaction, for the sale and leaseback of a 45-percent interest in certain used computer equipment. The format of these transactions was the same as the Funding-Pluto-SLG transaction; Knight conveyed to SLG a 45 percent interest in the equipment that was the subject of the sale and leaseback between O.P.M. and Knight.

O.P.M. entered into an agreement to sell certain computer equipment to Knight, subject to the lien of the Lender and the rights of the user. The purchase price was $5,005,655, payable $25,000 in cash, $25,000 by negotiable promissory note due July 31, 1978, without interest, and $4,955,655 by limited recourse promissory note.

The limited recourse note was payable in 96 monthly payments with interest at the rate of 10.2 percent. The first 18 monthly payments on the long-term note consisted exclusively of interest in the amount of $42,123 each. The payment on the long-term note for each of the remaining months was $87,166.01. Pursuant to the terms of the long-term note, however, Knight executed and delivered to O.P.M. a non-interest-bearing promissory note in the principal amount of $125,000, due July 31, 1978, that rep-

resents $20,833.33 on each of the first six months' payments on the long-term note. Also, on June 30, 1978, pursuant to the long-term note, Knight executed and delivered to O.P.M. a promissory note in the principal amount of $138,000, bearing interest at the rate of eight percent and due March 31, 1979. The $138,000 note represents $11,500 of each of the next twelve months' payments on the long-term note.

Knight leased the equipment back to O.P.M. on June 30, 1978, for a term extending through June 30, 1986. O.P.M. agreed to pay the following rent: $21,644.67 for each of the first six months of the lease; $30,978 for each of the next twelve months; and $87,521.01 for each of the remaining 78 months of the lease. The lease agreement provided that "Lessee [O.P.M.] will indemnify Lessor and protect, defend and hold it harmless from and against any and all loss, cost, damage, injury or expense * * * which Lessor * * * may incur by reason of any breach by Lessee of any of the representations by, or obligations of, Lessee contained in this Lease * * *." Knight and O.P.M. also entered into a remarketing agreement for the period following the expiration of the lease. Pursuant to the remarketing agreement, Knight agreed to pay O.P.M. ten percent of all net proceeds O.P.M. derived from the remarketing.

Knight and SLG entered into a Purchase Agreement on June 30, 1978. SLG agreed to purchase from Knight a 45 percent interest in the equipment Knight had acquired from O.P.M. Knight assigned all of its rights and interests in the equipment and lease to SLG subject to the prior lien of the Lenders, the rights of the end users and the rights of O.P.M. pursuant to its agreements with Knight. SLG assumed all of Knight's obligations arising out of its purchase agreement, lease agreement and re-

marketing agreement with O.P.M. SLG did not assume Knight's debt obligations to O.P.M. The purchase price was $2,257,045, payable $11,250 in cash, $11,250 by negotiable promissory note due July 31, 1978, without interest, $4,500 by negotiable promissory note due March 31, 1979, without interest, and $2,230,045 by long-term promissory note. The $11,250 cash payment and the $11,250 note are 45 percent of the $25,000 cash payment and $25,000 note from Knight to O.P.M.

The long-term note was payable in 96 consecutive monthly payments with interest at the rate of 10.2 percent per annum. The payment terms on SLG's long-term note to Knight were exactly 45 percent of the corresponding terms of Knight's long-term note to O.P.M.. The first 18 payments consisted exclusively of interest in the amount of $18,955.33 each. The remaining payments of principal and interest was $39,224.71 each. On June 30, 1978, in partial satisfaction of the long-term note, SLG also executed and delivered to Knight non-interest-bearing promissory notes in the amounts of $33,750 and $22,500 under which SLG became obligated for $9,375 of each of the first six months' payments. Pursuant to the terms of the long-term note, SLG also on June 30, 1978, executed and delivered to Knight a $62,100 promissory note bearing interest at the rate of eight percent and due March 31, 1979. The $62,100 note represents $5,175 of each of the next twelve months' payments on the long-term note. The evidence shows that SLG paid these short-term notes, but does not indicate when SLG paid them. The parties stipulated that SLG is entitled to deduct the interest it paid on the $62,100 promissory note.

After reduction for the interest prepayments, SLG's required monthly payments to Knight pursuant to the long-term note were $9,580.33 for the first six months, $13,780.33

for the next 12 months and $39,224.71 for the remaining 78 months. The difference between 45 percent of the rental payments in the lease between Knight and O.P.M., which Knight assigned to SLG, and the amounts SLG was required to pay Knight on the long-term note was $160 per month. SLG anticipated that the transaction with O.P.M. and Knight would generate this monthly cash flow.

The long-term note contained provisions identical to SLG's note to Pluto for deferral, extension, set-off and discharge, *supra*, except for the parties (O.P.M. is substituted for Funding).

SLG and Petitioner

As of June 30, 1978, SLG expected the equipment to have a residual value at the end of the leasebacks on June 30, 1986, of at least seven percent, net of marketing fees and other expenses. SLG expected the residual value to decline to near zero by June 30, 1993 the deferral date in the long-term notes.

The parties stipulated that the transactions had economic substance and that SLG had a profit motive in entering into the transactions with Pluto and Knight. SLG, therefore, acquired a depreciable interest in the equipment on June 30, 1978. SLG used $4,962,000.45 as the basis of the equipment in computing its depreciation deductions on its Federal income tax returns.

SLG received $3,600 from Pluto and $2,280 from Knight on or shortly after February 28, 1980, representing the monthly cash flow from the transactions for the 18-month period from July 1978 through December 1979. SLG reported rental income, depreciation, and interest expense from the sale and leaseback transactions in 1979, 1980 and 1981 as follows:

	1979	*1980*	*1981*
Rental income ...	$480,366	$1,044,022	$1,041.862
Depreciation	(828,007)	(827,007)	(827,007)
Interest expense .	(640,532)	(479,255)	(418,905)

Petitioner reported and deducted its distributive share of partnership losses and investment interest expense for the years in issue on its Federal income tax returns as follows:

	1979	*1980*	*1981*
Income (loss).....	($19,074)	$11,926	$11,747
Interest expense .	(8,706)	(12,525)	(11,919)

The investment interest expense petitioner deducted for the taxable years 1979, 1980 and 1981 was less than its allocable share from SLG for those years because of the section 163 limitations. In its notice of deficiency, respondent disallowed all income and deductions from the SLG sale and leaseback transactions.

The Bankruptcies

O.P.M. began proceedings pursuant to Chapter 11 of the Bankruptcy Reform Act of 1978 on March 11, 1981. Funding began similar proceedings on October 23, 1981. In the course of the proceedings, SLG, Pluto and Funding agreed to an Assumption, Modification and Compromise of controversies with respect to the sale and leaseback transactions. SLG, Knight and O.P.M. entered into similar agreements. The bankruptcy court approved the modifications.

The agreements generally provided that SLG's cash flow of $200 and $160 per month, including amounts past due and amounts not yet due, would become unsecured general claims against Funding and O.P.M., respectively. Funding's and O.P.M.'s lease payments were reduced to

eliminate the cash flow. As a result, the lease payments from Funding to SLG, the note payments from SLG to Pluto and the note payments from Pluto to Funding were of equal amounts. Similarly, the lease and note payments between O.P.M., SLG and Knight were of equal amounts. The modifications also provided that the rent and note payments were to offset each other by debits and credits, and the order in which the rental and note payments were due was reversed.

Opinion

We must decide whether long-term promissory notes of petitioner's partnership represent valid debt. We hold that these notes were not valid indebtedness. We hold that additions to tax pursuant to sections 6651(a)(1) and 6653(a) are warranted. We also hold that none of petitioner's loss deductions from the partnership attributable to this indebtedness is allowable pursuant to section 465 and, therefore, that petitioner is liable for interest on a tax-motivated transaction pursuant to section 6621(c).

Petitioner, a trust, is a limited partner in a partnership that entered into transactions for the sale and leaseback of computer equipment. In each transaction, the Leasing Corporations purchased from and leased back to end users certain computer equipment, financed by institutional lenders. Next, the Leasing Corporations sold the equipment to and leased it back from the Intermediary Corporations. Then, the Intermediary Corporations sold the equipment and assigned the leases to petitioner's partnership, SLG. SLG's purchases were financed with relatively small cash down payments, and long-term promissory notes labeled "recourse."

The sale and leaseback transactions between the Leasing Corporations, the end users and the Lenders were

arm's-length transactions between independent parties reflecting competitive rates and terms. See *Frank Lyon Co. v. United States* [78-1 USTC ¶ 9370], 435 U.S. 561 (1978). Respondent does not dispute the reality of the transactions between the Leasing Corporations and the end users. Moreover, the parties have stipulated that the transactions at issue had economic substance and that SLG had a profit motive. That a transaction has economic substance, however, "does not necessarily imply * * * that each part of the transaction is genuine." *Bussing v. Commissioner* [Dec. 44,342], 89 T.C. 1050, 1058 (1987) (supplemental opinion).

Respondent challenges the validity of the long-term notes issued by SLG in its transactions with the Intermediary Corporations. Respondent contends that these long-term notes were unenforceable and mere contingencies. Petitioner argues that the notes represent valid indebtedness because they could be enforced if the Leasing Corporations declared bankruptcy and the underlying leases were rejected by a trustee in bankruptcy.

A note which does not represent genuine indebtedness can neither be included in basis nor support a deduction for interest expense. *Knetsch v. United States* [60-2 USTC ¶ 9785], 364 U.S. 361 (1960); *Bussing v. Commissioner* [Dec. 43,722], 88 T.C. 449, 463 (1987), supplemental opinion [Dec. 44,342] 89 T.C. 1050 (1987). A valid debt is an enforceable and unconditional promise to pay money. *Linder v. Commissioner* [Dec. 34,603], 68 T.C. 792, 796 (1977). A contingent obligation is not true debt. E.g., *Estate of Baron v. Commissioner* [Dec. 41,515], 83 T.C. 542, 550-553 (1984), affd. [86-2 USTC ¶ 9622] 798 F.2d 65 (2d Cir. 1986).

SLG had the right, pursuant to the terms of the long-term notes, to defer any payment to the extent rental

payments from Funding and O.P.M. were overdue. More importantly, the long-term notes provided that any deferred amounts reduced unpaid principal and interest outstanding at the termination of a lease. SLG's obligation to make payments on the long-term notes, therefore, was specifically subject to Funding's or O.P.M.'s paying the rent due in the lease agreements.

The notes also provided that if the Leasing Corporations defaulted and their leases were terminated, any unpaid amounts on Pluto's or Knight's limited recourse notes would be deferred until June 30, 1993. O.P.M.'s and Funding's long-term notes to the institutional lenders were nonrecourse. The residual value of the equipment was expected to be near zero on June 30, 1993. Consequently, Pluto's and Knight's notes, as well as O.P.M.'s and Funding's notes, could be satisfied by forfeiting the near worthless equipment. In addition, the lease agreements provided that a default on the lease obligations would give rise to a right of indemnification of the lessor, SLG, against any resulting loss, cost, damage, injury or expense. Any rent not realized by SLG due to O.P.M.'s or Funding's default on the lease would appear to be a loss, cost, damage or injury subject to indemnification. An amount owed by O.P.M. or Funding for indemnification would be a "Past Due Sum" under the lease, which, if not paid, would reduce the unpaid principal and interest on the long-term notes pursuant to the setoff provisions, and SLG would not be required to pay its notes. SLG, therefore, was not unconditionally obligated to pay the debt represented by the long-term notes.

We have found that genuine debt exists in a sale and leaseback transaction where the obligor was responsible for the monthly note payments regardless of whether its lessee paid the rent. *Gefen v. Commissioner* [Dec. 43,600],

87 T.C. 1471, 1494 n.15 (1986). We have also observed that a debt may be valid if the note does not require payment solely out of rental income. *Cooper v. Commissioner* [Dec. 43,633], 88 T.C. 84, 111 (1987). Neither circumstance exists in these transactions.

Pursuant to the terms of the long-term notes, SLG had no obligation to "pay" on the notes except to the extent of Funding's or O.P.M.'s rental obligation. Prior to the bankruptcy proceedings, SLG was due $200 and $160 more than Funding's and O.P.M.'s rental payments each month. Some of this cash flow was never paid. SLG's note payments in effect were due solely out of rental receipts. Moreover, SLG was responsible for the monthly note payment only if the Leasing Corporations paid the rent.

Petitioner argues that the notes represent valid indebtedness because of the potential effects from the possibility that Funding or O.P.M. would declare bankruptcy. Petitioner contends that a trustee-in-bankruptcy or debtor-in-possession could reject the leases, and no rental would be "past due" because no rental would become legally "due" after rejection of the leases. Under this theory, SLG would have no right to offset the note payments with the unpaid rentals and would be subject to claims for collection on the notes. In petitioner's view, SLG would be liable on the notes and have only a claim as a general creditor against the bankrupt estate.

This argument turns on three speculative possibilities: (1) that O.P.M. and Funding would declare bankruptcy, (2) that the leases would be rejected in bankruptcy, and (3) that SLG's note would be regarded as having significance independent of the lease agreement. First, we cannot accept the implausible argument that SLG entered these transactions with a view that the Leasing Corporations would declare bankruptcy. Particularly in light of

the stipulation that SLG had a profit motive, we do not believe that SLG anticipated the bankruptcy of the Leasing Corporations (which would eliminate its cash flow and reduce its potential for realizing any residual value). Second, the evidence does not suggest that bankruptcy was a realistic or anticipated event in 1978, 1979 or 1980. We, therefore, disregard it for those years. Third, even considering the possibility of bankruptcy and its potential effects on the various network of agreements and legal obligations, particularly on the leases and on the long-term indebtedness, we do not believe that the stated indebtedness was real.

The Leasing Corporations did in fact declare bankruptcy in 1981. The actual consequences of the bankruptcies, however, support our holding that the long-term notes did not represent genuine indebtedness. The trustee-in-bankruptcy and debtor-in-possession for the respective Leasing Corporations did not reject the leases and attempt to collect on SLG's notes. Instead, SLG, the Intermediary Corporations and the Leasing Corporations agreed to modify the long-term notes. Pursuant to their agreement, SLG's cash flow was eliminated; the rent payments were modified to equal the note payments. The modifications reversed the priority of payments so that note payments were to be credited prior to the Leasing Corporations' rental payments, but SLG retained the offset and deferral rights contained in the original notes. Even for 1981, therefore, the year the Leasing Corporations actually had declared bankruptcy, SLG did not have an unconditional obligation to pay the amounts of the long-term notes. The closed circularity of the offsetting rent and debt obligations persisted; the change was in form only—to invert the subtrahend and the minuend, i.e., the rent was to be subtracted from the debt; previously, the debt had been

subtracted from the rent. Moreover, had the leases been disaffirmed, we believe SLG had substantial legal arguments that the notes were *not* recourse but that the obligations on the notes were impliedly wholly dependent on realizing rentals under the lease agreement. We do not decide this issue, however, because we do not decide hypothetical cases.

In addition, the recourse notes SLG executed for the prepaid interest required by the long-term notes further support our holding. These recourse notes obligate SLG for some of the same interest payments the long-term notes already required. Such redundancy is further evidence that no unconditional obligation existed pursuant to the long-term notes, and the parties knew it. The long-term notes provided for interest prepayments in the following amounts:

	SLG to Pluto	*SLG to Knight*
Due 1978	$70,000	$56,250
Due 1979	89,000	62,100

Despite the existing "obligation" for these same amounts in the long-term notes, SLG also executed recourse notes in the same amounts to Pluto and Knight (these notes were identical to the recourse notes on which the Intermediary Corporations were obligated to the Leasing Corporations). These notes do not include deferral and set-off provisions.

Petitioner relies on *Levy v. Commissioner* [Dec. 45,152], 91 T.C. 838 (1988), a cause factually very similar to this case. The structure of the sale and leaseback transactions in *Levy* is almost identical to the transactions at issue. In *Levy*, a leasing corporation, DPF, purchased computer equipment, financed by an institutional lender, and leased it to an end user. The leasing company then sold the

equipment to another company, AARK, for relatively small cash payments, and long-term promissory notes. AARK sold the equipment to the taxpayer, also for relatively small cash payments, and long-term promissory notes. The notes provided that the taxpayer's liability on the notes would be discharged by any amount AARK owed and failed to pay DPF or the institutional lender. The taxpayer leased the equipment back to the leasing company. We found that the taxpayer's notes represented valid debt obligations. 91 T.C. at 870-871.

The discharge provisions in the notes in *Levy*, however, were very different than the setoff and discharge provisions in SLG's long-term notes. In *Levy*, the discharge provisions protected the investor from making the same payment twice if the intermediary or leasing corporation failed to use the payment to make its own debt payment. Also, the investor had the option of making a debt payment directly to the leasing corporation if the intermediary corporation was delinquent in its payments to the leasing corporation. 91 T.C. at 870. No other protection was provided for the investors.

In these transactions, SLG's deferral rights were much broader. SLG could defer payment on the notes to the extent it did not receive rentals. When the lease ended, SLG could offset the notes with the deferred amounts. *Levy*, therefore, does not support petitioner's argument.

Additions to Tax

Respondent determined an addition to tax pursuant to section 6651(a)(1) for 1979. Section 6651(a)(1) provides for an addition to tax for failure to file a Federal income tax return on time unless the taxpayer shows that the failure to file was due to reasonable cause and not willful neglect.

The addition is five percent of the correct tax for each month the return is not filed, to a maximum of 25 percent. Sec. 6651(a)(1). A taxpayer may show reasonable cause for late filing if he "exercised ordinary business care and prudence" in his attempt to file timely. Sec. 301.6651-1(c)(1), Proced. & Admin. Regs.

Petitioner filed its 1979 tax return on November 5, 1981, more than eighteen months after the April 15, 1980, due date. Petitioner argues that its trustee relied on an employee to file the return and that when its trustee discovered that the employee had not filed the return, the trustee made all reasonable efforts to have the return filed as quickly as possible.

In general, a taxpayer has a personal, nondelegable duty to file the return when due and reliance on an agent does not constitute reasonable cause. *United States v. Boyle* [85-1 USTC ¶ 13,602], 469 U.S. 241 (1985); *Logan Lumber Co. v. Commissioner* [66-2 USTC ¶ 9605], 365 F.2d 846, 854 (5th Cir. 1966), affg. on this issue a Memorandum Opinion of this Court [Dec. 26,785(M)]. If the taxpayer knows a return is required but entrusts the responsibility of preparing the return to a third person, that person's failure is not reasonable cause for the taxpayer's failure. *United States v. Boyle, supra*; *Latham Park Manor, Inc. v. Commissioner* [Dec. 34,733], 69 T.C. 199, 219 (1977), affd. without published opinion 618 F.2d 100 (4th Cir. 1980).

Petitioner's trustee entrusted the responsibility for filing the 1979 return to his employee. The trustee, a tax attorney, knew when the return was due and certainly did not rely on his employee for advice. The trustee cannot avoid responsibility by blaming a clerical employee, particularly if, as the evidence suggests, the trustee did

not exercise responsible oversight of the clerical employee's performance. The clerical employee's failure is, in short, the responsibility of the trustee. The employee's failure cannot excuse the delinquent filing of petitioner's return. We sustain respondent's determination of the section 6651(a)(1) addition to tax for 1979.

Respondent also determined additions to tax pursuant to section 6653(a) for the taxable years 1979 and 1980. Section 6653(a), as in effect in 1979 and 1980, provided for an addition to tax equal to five percent of an underpayment if any part of the underpayment was due to negligence or intentional disregard of the rules or regulations.

For purposes of section 6653(a), negligence is defined as lack of due care or failure to do what a reasonable and prudent person would do under the circumstances. *Neely v. Commissioner* [Dec. 42,540], 85 T.C. 934, 947 (1985). Respondent's determination is presumptively correct, and petitioner has the burden of proof on this issue. Rule 142(a), Tax Court Rules of Practice and Procedure. We have held that the losses petitioner claimed on its 1979 and 1980 returns related to the long-term notes are not allowable. The business and tax experience of petitioner's trustee, a tax attorney, as evidenced by his testimony and participation in the trial and briefing in this case, is extensive, and we believe that he knew that at best the long-term note represented a mere contingency and was not valid debt. For a trustee with such knowledge of the tax law, taking losses based on a note that does not represent valid indebtedness is negligent. We sustain respondent's determination on this issue.

We next consider whether petitioner is liable for the additional interest imposed on underpayments attributable to tax motivated transactions pursuant to section 6621(c), formerly section 6621(d). Section 6621(c) provides for an

increase in interest to 120 percent of the applicable rate for underpayments exceeding $1,000 attributable to tax motivated transactions. The term "tax motivated transaction" includes "any loss disallowed by reason of section 465(a)." Sec. 6621(c)(3)(A)(ii).

We believe that the language of section 6621(c)(3)(A)(ii) includes losses disallowed by reason of invalid debt. First, section 465(a) does not operate to disallow losses, rather it operates to allow losses. Consequently, unless a loss is allowable under section 465(a), it must be a "loss disallowed by reason of section 465(a)." Second, if debt is not valid, the putative principal amount of the "debt" cannot be "an amount borrowed." If there is no "amount borrowed," then the taxpayer cannot be at risk within the meaning of section 465(a). If the taxpayer is not "at risk" the loss is not allowable within the meaning of section 465.

Petitioner's losses are disallowed because they arise out of long-term notes that do not represent genuine indebtedness. As a result, the principal amounts of the long-term notes do not constitute "amounts borrowed" for which petitioner could be at risk. See secs. 465(a), 465(b)(1); *Waddell v. Commissioner* [Dec. 43,023], 86 T.C. 848, 914 (1986), affd. [88-1 USTC ¶ 9192] 841 F.2d 264 (9th Cir. 1988). Petitioner is not at risk within the meaning of section 465(a) for amounts that are not valid debt. See *Baughman v. Commissioner* [Dec. 45,476(M)], T.C. Memo. 1989-59, on appeal (5th Cir., May 1, 1989). The underpayment attributable to the long-term notes exceeded $1,000. Consequently, we sustain respondent's increase to interest pursuant to section 6621(c).

Decision will be entered under Rule 155.